IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1960

No.

AMERICAN STATE BANK,
(A Wisconsin banking corporation)

Plaintiff-Petitioner,

vs.

THE UNITED STATES OF AMERICA,

Defendant-Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioner, American State Bank, plaintiff and appellant in the Courts below, prays that a writ of certiorari issue to review the judgment herein of the United States Court of Appeals for the Seventh Circuit.

Said judgment, affirming the Federal District judgment in dismissing the actions, was entered on June 13, 1960. The opinion of the Court of Appeals was released on June 13, 1960. There was no motion, request or petition for rehearing.

OPINIONS BELOW

The Findings of Fact and Opinion of the United States District Court for the Eastern District of Wisconsin is reported at 176 F. Supp. 64, 4 A.F.T.R. 2d 5540 and is printed in the record below (Record 6a-18a). The opinion of the Court of Appeals for the Seventh Circuit (Appendix A, infra, pp. 27-36) is reported at .... F. 2d ..... (U.S.C.A. 7), 5 A.F.T.R. 2d 1678.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Seventh Circuit was dated and entered on June 13, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

(1) Whether a bad debt reserve allowance by the Commissioner of Internal Revenue that prejudicially discriminates against plaintiff-appellant Bank by being a small fraction of the allowance granted comparable and competing banks is "reasonable" as required by the Internal Revenue Code.

(2) Whether such allowance of the Commissioner can be upheld by the lower Court as being "reasonable" for reasons that contradict the published statements of the Tax Writing Committees of Congress respecting bad debt reserve procedures.

(3) Whether Mimeograph 6209 (C.B. 1947-2, Page 26), and related Revenue Rulings, are based upon valid premises reflecting the intent of the Internal Revenue Code on matter of bad debt reserve procedures as applicable to banks.

(4) Whether the Commissioner's premises for promulgating Mimeograph 6209, or the mathematical formula provided in the Mimeograph, are controlling on matter of determining a "reasonable" bad debt reserve addition for a bank.

(5) Whether a bad debt reserve allowance of the Commissioner of Internal Revenue under Mimeograph 6209 meets the test of being "reasonable" even though providing a result completely contradictory to the premises upon which said Mimeograph is based.

STATUTES, REGULATIONS AND RULINGS INVOLVED

The statutory provisions involved are Section 23(k)(1) of the Internal Revenue Code of 1939 (26 USC 23(k)(1)-1952 Ed., Volume 3, p. 3296) and its successor Section 166(c) of the Internal Revenue Code of 1954 (26 USC 166(c) 1952 Ed.-Supp. IV, Volume Two, p. 1518); the regulations involved are Treasury Regulations 118, Sections 39.23(k)-1 and 39.23(k)-5 promulgated under the Internal Revenue Code of 1939, and Treasury Regulations 1.166-1 and 1.166-4 promulgated under the Internal Revenue Code of 1954; and, the rulings involved are Internal Revenue Mimeograph 6209 (C.B. 1947-2, page 26); Revenue Ruling 54-148 (C.B. 1954-1, page 60) and Revenue Ruling 57-350 (C.B. 1957-2, page 144), all of which are set forth in Appendix B, infra, pp. 38-50.

STATEMENT OF THE CASE

The present tax controversy involves the question of income tax deductions premised upon reasonable addi-

tions to the bad debt reserve of plaintiff-appellant Bank (petitioner) under Section 23(k)(1) of the 1939 Revenue Code (for 1953), and its successor, Section 166(c) of the 1954 Revenue Code (for 1954 and 1955).

The plaintiff-appellant, American State Bank, was organized as a banking corporation under the laws of Wisconsin in 1931. During the year 1947 plaintiff-appellant moved its banking office from South Second Street and West National Avenue in Milwaukee, Wisconsin, to its present address at 740 North Plankinton Avenue, which location is within the downtown area of Milwaukee, Wisconsin. (Record 8a)

Beginning with the taxable and calendar year 1945, plaintiff-appellant changed to the reserve method of treating bad debts for Federal income tax purposes with the consent of the Commissioner of Internal Revenue. (Record 8a)

Under the reserve method a taxpayer such as plaintiff-appellant is entitled to deduct for Federal income tax purposes a reasonable addition to a reserve for bad debts, instead of deducting debts which became worthless within the taxable year.

In case of bad debt reserve procedure of banks for income tax deduction purposes, the Commissioner has provided by published rulings a procedure for determining a bank's annual accruing loss by reliance upon a 20-year bad debt loss experience pattern. Briefly described, such procedure involves determining the ratio of a bank's bad debt losses to loans over a consecutive 20-year period, and then applying the ratio to outstanding loans at end of the taxable year so as to obtain the annual addition to the reserve (and tax deduction for the year).

The published rulings provide a "ceiling", mathematically computed, so as to prevent accumulation of additions (and tax deductions) to a point that could represent an excessive reserve. Provision is also made for substitution of loss experience of other banks for years (in the 20 consecutive year period chosen) when the bank was not in existence.

The bank bad debt reserve procedure is set forth in Mimeograph 6209, C.B. 1947-2, Page 26; Revenue Ruling 54-148, C.B. 1954-1, Page 60; and Revenue Ruling 57-350, C.B. 1957-2, Page 144.

Plaintiff-appellant Bank challenges the arithmetic application of the Commissioner's rulings as cited to its bad debt reserve additions (and tax deductions) on ground that the result of the application did not provide "reasonable additions" to the bad debt reserve of plaintiff-appellant Bank for the years at issue, as commanded by the Statute (Section 23(k)(1) Internal Revenue Code of 1939, and Section 166(c) Internal Revenue Code of 1954); that the arithmetic computation under a formula completely rejects the very bases for promulgating the formula; and that the result in terms of tax treatment of plaintiff-appellant Bank is unreasonable, arbitrary, and prejudicially discriminatory, when considered in terms of bad debt reserve treatment accorded other banks.

Briefly stated, the controversy involves plaintiff-appellant Bank's request to use the substituted loss experience of other banks in its 20-year experience period for years in which the Bank had no true loss experience (as recognized by the District Court), and the denial of the request by the Commissioner.

From standpoint of dollars, the additions to the bad debt reserve as deducted on tax returns filed by plaintiff-appellant, which additions are the basis of the Claims for Refund that are the subject of this litigation, and as allowed and disallowed by the Commissioner, are as follows:

	1953	1954	1955
Deducted on tax return filed	$42,392.16	$95,640.84	$81,576.62
Allowed upon original Revenue Agent's examination	$30,087.80	$ 2,180.46	$ 5,507.14
Additional allowance upon examination of Claim for Refund	—	12,776.69	18,005.60
Total allowed as deductions	$30,087.80	$14,957.15	$23,512.74
Amount Disallowed	$12,304.36	$80,683.69	$58,063.88

The additional allowance respecting bad debt reserves as allowed upon examination of plaintiff-appellant's Claims for Refund for the years 1954 and 1955 reflects entirely the promulgation of the Commissioner of Internal Revenue's Revenue Ruling 54-148, C.B. 1954-1, Page 60. This Revenue Ruling allowed a bank taxpayer to use any 20 years after 1927 in lieu of a 20-year period ending with a taxable year, which Revenue Ruling (so plaintiff-appellant contends) showed tacit recognition of the point that under any procedure of using 20 consecutive years ending with the taxable years the heavy bank bad debt loss years of the Great Depression were being eliminated.

The amount of taxes here at issue, and computed after a partial refund of the Claims for Refund filed by plain-

tiff-appellant Bank for the years here at issue are as follows:

Year	Amount of refund in income taxes at issue
1953	$ 6,320.54
1954	41,955.52
1955	30,193.21

The petitioner (plaintiff-appellant) commenced action for recovery of income taxes represented by disallowed claims for refund against respondent in the District Court of the United States for the Eastern District of Wisconsin. The said Court had jurisdiction pursuant to Section 1346 of Title 28 of the United States Code (28 U.S.C. 1948 Ed. Section 1346). The court of original jurisdiction dismissed plaintiff-appellant Bank's suit, and thereafter upon appeal, the United States Circuit Court of Appeals for the Seventh Circuit affirmed the District Court's dismissal of the action.

A United States Supreme Court decision in the instant case would not only decide such case, but would also eliminate the confusion of conflicting court decisions in the very important area of income tax treatment for the Nation's banks, and would terminate further continuous litigation of the issue by banks.

REASONS FOR GRANTING THE WRIT

I. The Lower Court Decision Prejudicially Discriminates in the Income Tax Treatment of Plaintiff-Appellant Bank, and Is in Direct Conflict With Two Decisions of the United States Court of Claims.

This case concerns income tax deductions of plaintiff-appellant Bank intended to represent "reasonable" additions to its bad debt reserve as commanded by the Internal Revenue Code. Plaintiff-appellant, in the courts below, insisted that the Commissioner's determination was unreasonable and unfair, and presented evidence as to what was "reasonable", including evidence as to the tax treatment of comparable, and competing, banks.

The Commissioner of Internal Revenue, beginning some 13 years ago, has recognized that banks were in a special situation on matter of bad debt reserves, because of repetitive loan procedures, and long term loans, so as to require a type of "depreciation reserve" treatment to determine the "annual accruing loss" as a bad debt reserve addition. Accordingly, the Commissioner promulgated Mimeograph 6209, C.B. 1947-2, Page 26; Revenue Ruling 54-148, C.B. 1954-1, Page 60; and Revenue Ruling 57-350, C.B. 1957-2, Page 144. In general, these Rulings permit each bank to compute a 20-year average of bad debt losses to loans, and then apply such loss ratio to outstanding loans at close of the taxable year to determine such year's bad debt reserve addition, and tax deduction, as reflecting the "probable annual accruing loss" for the year. Applicable to years after 1953, a bank may choose any consecutive 20-year period, whether the bank was in existence during such period or not, and for that portion of the 20-year period selected during which the

bank was not in existence, the bank may fill in such years with the bad debt experience of other similar banks.

As the cited Rulings emphasize the 20-year period is intended to constitute a reasonable cycle of good and bad (heavy loss) years. The evidence introduced at trial below proves the "bad years" (heavy loss years) for banks were the years 1932 to 1936, inclusive. Originally Mimeograph 6209 (C.B. 1947-2, Page 26) (Appendix B, infra, p. 44) required use of a period of 20 consecutive years ending with the taxable year, and until the taxable (calendar) year 1952, such "bad years" of 1932 to 1936 were included in the 20-year period. However, by close of the taxable year 1955 all of these "bad years" would be eliminated from any consecutive 20-year period ending with the taxable year. In 1954, and just before the loss effect of the last of the "bad years" would be removed from any bank's 20-year loss ratio, the Commissioner promulgated Revenue Ruling 54-148 (C.B. 1954-1, Page 60) (Appendix B, infra, p. 47) permitting banks to choose any 20 consecutive years' loss period, thus assuring a loss ratio that would include "bad years".

Plaintiff-appellant Bank (Petitioner) was organized in 1931, and did not have normal bad debt loss experience during the "bad years" of 1932-1936. The District Court stated that—

> "* * * plaintiff Bank * * * had little or no experience for several of the heavy loss years due to its newness and economic factors, * * * " (Record 18a)

Accordingly, in computing its loss experience ratio for the 20-year period of 1928-1947, plaintiff-appellant substituted the loss experience of similar banks for the years 1928 to 1936, inclusive, the substitute experience being

the average of Seventh Federal Reserve Member Banks for each of said years.

The final determination of the Commissioner (upon consideration of refund claims) allowed substitute experience for the years 1928 to 1931, when plaintiff-appellant was not in existence, but denied substitute experience for the "bad years" of 1932 to 1936, when plaintiff-appellant was in existence.

In course of proving what was "reasonable", plaintiff-appellant emphasized (in both the District and Appellate Court) that the amounts allowed by the Commissioner could not be "reasonable", because such amounts were based upon a loss ratio that was a mere fraction of that allowed by the Commissioner to comparable, and competing, Milwaukee, Wisconsin banks, viz:

Bad Debt Loss Ratio Allowed American State Bank	Bad Debt Loss Ratio Allowed The Bank of Commerce	Bad Debt Loss Ratio Allowed Marshall & Ilsley Bank
0.14808% (1953) or 0.2608% (1954 & 1955) (Record 8a)	0.9801% (Record 38a)	0.758289% (Record 37a)

Plaintiff-appellant also introduced evidence that the average bad debt loss experience ratio for all banks in the Seventh Federal Reserve District (in which plaintiff-appellant was located) for 1928 to 1947 was 0.833%. (Record 30a)

Such evidence demonstrated what was reasonable for banks generally, and for competing banks, and demonstrated also that the Commissioner had been arbitrary in his prejudicial discrimination against plaintiff-appellant.

The Federal District Court not only recognized, but commented upon, the prejudicial discrimination (disadvantageous position) of plaintiff-appellant under the Commissioner's determination, viz:

> "One further observation may be noted. While the record here does not support a finding of present or anticipated future losses which establish the insufficiency of the allowed additions to reserves or of the inadequacy of the accumulated reserve, it nevertheless demonstrates the Bank's disadvantageous position in respect to deductions from income for tax purposes relative to comparable Milwaukee banks.
>
> "The Commissioner's application of the method proposed in the pertinent Rulings results in substantially larger proportionate deductions being available to banks having sustained heavy losses and to those organized subsequent to the heavy loss years than to banks newly organized during these years. Such deductions may be justified in case of banks actually having sustained proportionate losses. However, the disparity between the position of hypothetical banks which had no experience since they were not in existence and may rely on borrowed heavy loss experience, and that of plaintiff Bank which had little or no experience for several of the heavy loss years due to its newness and economic factors, but is denied the use of substituted loss experience, may result in the application of the Commissioner's formula in a discriminatory manner.
>
> "Tax disadvantage and potential discrimination have not been considered pertinent factors in judging the reasonableness of the Commissioner's determinations as to additions to reserves as deductions from income. The Bank has not met its heavy burden of showing that the Commissioner's determinations in question here are unreasonable or arbitrary." (Record 17a-18a)

However, neither the Federal District Court, nor the United States Circuit Court of Appeals for the Seventh Circuit paid heed to the prejudicial discrimination factor in passing upon the issue of a reasonable addition to the bad debt reserve of plaintiff-appellant. The Federal District Court held that so long as amounts allowed as bad debt reserve additions exceeded the actual bad debts charged against the reserve, the plaintiff-appellant was not in position to complain.

In brief, both the Federal District Court and the Appellate Court determined that irrespective of the income tax treatment accorded other, and competing Milwaukee banks, the Commissioner's determination as applied to plaintiff-appellant was "reasonable".

In ignoring the obvious prejudicial discrimination, the decision of the lower court is in direct conflict with the determination of the United States Court of Claims in *Exchange Parts Co. of Fort Worth v. U.S.*, (June 8, 1960), ... Ct. Cl. ....., 279 F. 2d. ....., Prentice-Hall 1960 Federal Taxes, para. 196,032, wherein the Court refused to accept a professed distinction as applied to the particular taxpayer, and held that the taxpayer could not be validly made the object of prejudicial discrimination. To the same effect, *Connecticut Railway and Lighting Co. v. U.S.*, 135 Ct. Cl. 650, 142 F. Supp. 907. The United States Court of Claims in the latter case rejected the Government's disclaimer of reliance upon a Regulation with an express provision for discrimination, and determined that such disclaimer "cannot erase the fact of the discrimination". In like manner, the reliance of the courts below upon a standard of determination different from that publicly promulgated and followed by the Commissioner "cannot erase the fact of the discrimination".

It need not be argued that the determination of the Commissioner here at issue made the plaintiff-appellant Bank the object of prejudicial discrimination for the simple reason that the District Court went to substantial length to point to the prejudicial discrimination in course of its opinion.

It is respectfully asserted that the United States Supreme Court should determine whether the two decisions of the United States Court of Claims, or the decision of the United States Circuit Court of Appeals for the Seventh Circuit in the instant case are to be followed. In brief, the Supreme Court should determine whether a Federal income taxpayer can be made the object of prejudicial discrimination.

II. The Lower Court Decision Is Founded Upon a Legal Conclusion in Conflict With Published Conclusions of Legislative Committees of Congress Made Upon Enacting a Related Income Tax Provision.

As emphasized in other portions of this "REASONS FOR GRANTING THE WRIT", Mimeograph 6209 (Appendix B, infra, p. 44), and related Revenue Rulings, was intended to permit banks to establish bad debt reserves providing for possible future losses. Said Mimeograph actually provides for banks setting up a reserve for loss of capital that "does not differ materially from a reserve for depreciation which is set up on a percentage basis rather than on basis of actual depreciation suffered". In the instant case the intent and purpose of Mimeograph 6209 is completely set aside upon the Appeals Court stating —

> "* * * The fallacy of the Bank's position in this case is that it attempted to set up a contingency reserve

> account for possible future losses and not a reasonable allowable deduction for bad debt reserve for income tax purposes as provided by Section 23(k)(1), 166(a), 26 U.S.C.**"
> (citing *S.W. Coe & Co. v. Dallmann*, 7 Cir., 1954, 216 F. 2d 566).

Such Court pronouncement ignores what Congressional Tax Writing Committees have acknowledged and recognized, i.e., that under the bad debt reserve procedure supplied for banks under Mimeograph 6209 there is the condition of establishing a reserve for possible future losses. Such recognition was not only acknowledged, but accepted by Congress, in course of enacting related tax legislation for banks in the Revenue Act of 1951, in which legislation banks on the bad debt reserve basis were allowed a different treatment for Korean Excess Profits Tax purposes.

In case of the House Ways and Means Committee, it was recognized that banks which had followed Mimeograph 6209 beginning in 1947 (when Mimeograph 6209 was first applicable) would have accumulated reserves to "the allowable maximum", which could only mean that the reserves, as accumulated, were in anticipation of future losses. Otherwise, reserve additions would have been absorbed by bad debt loss charge-offs. Incidentally, the Ways and Means Committee also recognized that actual bad debts could be expected to be abnormally low during boom-time conditions, the full statement in recognition, and acceptance, of the special bad debt reserve treatment of banks being as follows —

> "For income tax purposes, banks have been permitted to use the reserve method of accounting for bad debts. The banks which elected to use this method, beginning in 1947, have for the most part

accumulated reserves which equal or approach the maximum allowable under the existing rulings. The fact that the reserves have reached or approached the allowable maximum, plus the probability that losses from bad debts will be abnormally low during the excess profits tax years, means that the deduction in the excess profits tax period will be comparatively low. To permit an equitable comparison between the base-period net income and the income of the excess profits tax years, the bill permits banks using the reserve method of accounting for bad debts to claim a deduction for the purpose of determining excess profits tax net income on the basis of debts which become worthless in whole or in part during the taxable year." H.R. Rep. No. 3142, 81st Cong., 2d Sess., p. 14, 1951-1 C.B. 187, 196.

In practically identical fashion, the Senate Finance Committee made similar observations on point of Congressional understanding, and acceptance, on point of what banks were permitted to do under the special bad debt reserve treatment provided by Mimeograph 6209, viz:

"Banks which have elected to use the reserve method of accounting for bad debts for income tax purposes substitute for excess profits tax purposes a deduction for debts which became worthless in whole or in part within the taxable year. This is desirable because the banks which elected to use the reserve method for income tax purposes beginning in 1947 have for the most part accumulated reserves that equal or approach the maximum allowable under the existing rulings. In view of this situation and because of the probability that losses from bad debts will be comparatively low during the excess profits tax years it is likely that the deductions under the reserve method will be abnormally low during the excess profits tax period. The deduction of such losses as they occur will provide a more equitable

result." S. Rep. No. 2679, 81st Cong., 2d Sess., p. 15, 1951-1 C.B. 240, 250.

Even though legislative committees of Congress have accepted a bad debt reserve treatment for banks generally which allows accumulation of reserves in anticipation of possible future losses, and even though many banks throughout the entire United States have actually accumulated bad debt reserves in anticipation of possible future losses, the lower court is, in effect, denying the validity of the bad debt reserve treatment accorded banks generally. The lower Court, by a slavish adherence to the formula procedure of Mimeograph 6209, denies plaintiff-appellant the treatment intended by both the Mimeograph and Congress. The denial was acknowledged in the opinion of the Federal District Court in the instant case, but without acceptance of the obvious, because the District Court followed the erroneous court pronouncements in prior cases having unrelated issues.

Only the United States Supreme Court can remove the anomaly where the lower Court is denying to plaintiff-appellant a tax treatment that the Commissioner of Internal Revenue has publicly pronounced as policy, and Congress itself has accepted as "reasonable" in process of enactment of related income tax legislation applicable to banks.

III. The United States Supreme Court by Deciding the Instant Case Will Dispel the Confusion of Conflicting Court Decisions on Commissioner's Mimeograph 6209 Involving Bad Debt Reserve Procedure of All Banks for Income Tax Purposes, and Terminate Continued Litigation.

On the matter of bank bad debt reserve tax deductions generally, and the applicability of Mimeograph 6209 specifically, the few court decisions (including the decision below) reflect an area of confusion. Further litigation can be expected in view of the existing confusion. Consideration of the instant case by the United States Supreme Court, and a decision by the Supreme Court in this particular case, should dispel the confusion, and terminate continuous litigation by the Nation's banks. The instant case is particularly pertinent in reflecting the various issues heretofore litigated in other courts, but with no established "ground rules" resulting.

A brief summation of the available decisions of lower courts on this issue clearly emphasizes the point of confusion as to whether Mimeograph 6209 has, or has not, the force of law.

In the case of *The First National Bank at Wilkinsburg v. United States,* T. C. Memorandum Opinion (June 25, 1954) published in 1954 T. C. Memorandum Decisions of Prentice-Hall, Page 54-565, The United States Tax Court specifically commented respecting Mimeograph 6209, C.B. 1947-2, Page 26, in the words —

> "That Mimeograph does not have the force and effect of law."

In the case of *First National Bank of La Feria,* 24 T.C. 429 (June 20, 1955), affirmed 234 Fed. 2d 868, the

same United States Tax Court completely disregarded its own observations on point that Mimeograph 6209, C.B. 1947-2, Page 26, did not have the force and effect of law by showing that its determination was based upon Mimeograph 6209, C.B. 1947-2, Page 26.

Somewhat puzzling is the Tax Court's observation in said case, at Page 433, that the bad debt loss reserve is intended to compensate for past losses, viz:

> "The purpose of the 20-year experience in computing the reserve for bad debts is to equalize between past bad debt experience and future bad debt expectations so that a particular bank may be recompensed for past losses by bringing the reserve to a maximum figure, before charging the reserve with current losses, and to provide the bank with a cushion adequate to protect it against anticipated future losses. Once the maximum reserve is reached the charges and the credits should balance out over a period of years."

It is difficult to comprehend as to why a bank that charged off (and presumably deducted) bad debt losses when incurred during the Depression 1930's should be considered as being compensated once again for such losses in form of additions to a bad debt reserve.

In *Union National Bank & Trust Co. of Elgin*, 26 T.C. 537, the Tax Court ignored its own pronouncement (in *The First National Bank at Wilkinsburg*, T.C. Memorandum Opinion (June 25, 1954) published in 1954 T.C. Memorandum Decisions of Prentice-Hall, Page 54-565) to the effect that Mimeograph 6209, C.B. 1947-2, Page 26, does not have the force and effect of law by the following observations at Page 543 —

> "In this case, for the years 1949, 1950, and 1951, the Commissioner has applied the provisions of his

> ruling, Mim. 6209, 1947-2 Cum. Bull. 26, to petitioner. That ruling is declaratory of the Commissioner's position with respect to reasonable annual additions to reserves for bad debts by banks in general. * * *"

In the case of *Miners National Bank of Wilkes-Barre*, 33 T.C. No. 5 (October 14, 1959), the Tax Court decided once again (in spite of the Court's prior determinations that followed Mimeograph 6209, C.B. 1947-2, Page 26) that the Mimeograph does not have the force and effect of law, viz:

> "For some reason the parties have attempted to confine the Court to the very narrow question of whether the Commissioner properly interpreted his own Mim. 6209, 1947-2 Cum. Bull. 26 by determining that for the purpose of that Mimeograph F.H.A. Title II loans were in fact '100% Government guaranteed loans'.
>
> "We think this is not proper. Mim. 6209 does not have the effect of law and, certainly, neither do individual rulings under it have the effect of law. The fundamental question still is whether petitioner has proven error in the Commissioner's determination in this case."

The Court concluded —

> "We rest our holding, not on the narrow ground of whether or not F.H.A. Title II loans are '100% Government guaranteed', but on the broader ground that petitioner has not shown that the Commissioner in this case unreasonably exercised the discretion vested in him by law."

Amidst the confusion the United States District Court S.D. Texas, Houston Division, did correctly apply bad debt reserve tax deduction treatment in a case involving a production credit association in the business of making

loans. In that case, *Winter Garden Production Credit Association, Plaintiff, v. R. L. Phinney, Director of Internal Revenue, Defendant,* 139 F. Supp. 213, 49 A.F.T.R. 686, the taxpayer had a late start, and an abnormal loss pattern even as plaintiff-appellant, and the District Court appropriately rejected a mere arithmetic calculation of actual average losses in determining bad debt reserve additions, and tax deductions. The Federal District Court made the following observation (here pertinent) —

> "That being true, the question remains as to whether the Commissioner abused his discretion and, if so, to what extent. I am convinced that he did, and that the rate which the Commissioner determined is unduly low and unrealistic. I am convinced that this is so because the Commissioner's calculation does not take into account the highly significant fact that capable farm credit agencies suffered severe bad debt losses during the early 1930's; and the taxpayers here escaped this fate by reason of the fact that they were organized during the height of the depression days and that, with negligible exception, the farmers economic condition has prospered and improved during the taxpayers' entire history."

The same rule was correctly applied by the United States District Court, Dist. of S D., S. Div. in *Mitchell-Huron Production Credit Association, v. W. C. Welsh, District Director of Internal Revenue, Defendant,* 163 F. Supp. 883, 2 A.F.T.R. 2d 5504.

In the instant case, both the Federal District Court, and the Appeals Court, accept the determination in form of mathematical calculation made by the Commissioner

under Mimeograph 6209 and related Rulings, but reject (in course of their decisions) the premises upon which the Mimeograph and Rulings are based.

It is respectfully asserted that such confusion respecting the applicability, non-applicability, or partial applicability, of Mimeograph 6209 and related Revenue Rulings should be dispelled by the United States Supreme Court by considering the instant case which places in issue the question of legislative intent in prescribing "reasonable additions" to bad debt reserves. A decision by the United States Supreme Court would help all of the Nation's banks in an important area affecting their annual income tax deductions.

Such decision could terminate continued and unnecessary litigation.

IV. The United States Supreme Court by Deciding the Instant Case Will Remove the Anomaly of the Lower Court Accepting the Result of a Mathematical Formula Application, While Denying the Premises for Employment of the Formula.

In affirming the Commissioner's determination as to bad debt reserve additions, and tax deductions, being "reasonable" for plaintiff-appellant, both the District Court and the Appellate Court rejected completely the premises upon which the determination was made by the Commissioner, which premises, incidentally, affect the procedures of all of the Nation's banks that are on the bad debt reserve basis. Specifically, the lower court determined that plaintiff-appellant Bank was entitled to deduct as a reserve addition only the amount required to offset bad debts charged against the reserve with some vague reference to some allowance for "future losses".

In so doing the lower court completely rejected the Commissioner of Internal Revenue's premises for establishing a special bad debt reserve treatment for banks, even though the lower court accepted the mathematical determination under the formula supposedly reflecting the Commissioner's premises.

Mimeograph 6209 and related Revenue Rulings here at issue provide a method for banks computing a reasonable annual addition to a reserve for bad debts "indicative of the probable annual accruing loss". There is absolutely no requirement that the addition, and tax deduction, be limited to actual bad debt losses sustained. As a matter of fact, there would be no reason for employing the highly involved mathematical computations respecting a bank's 20-year loss experience, if only an amount equal to bad debt losses actually sustained in the particular year was to constitute the annual addition to the reserve, and the tax deduction.

Mimeograph 6209 directly contradicts any idea that reserve additions can only equal actual losses incurred with the statement —

> "Such a reserve for loss of capital does not differ materially from a reserve for depreciation which is set up on a percentage basis rather than on the basis of actual depreciation suffered."

It is true that Mimeograph 6209 recognized that any procedure resulting in an accumulation in the reserve for bad debts to point that would sanction "the deduction of a mere contingency reserve for losses", would, as the Mimeograph emphasizes, provide amounts not allowable as deductions for income or excess profits taxes. However, the Mimeograph specifically and intentionally insured against such result by supplying a "reasonable ceil-

ing on the accumulation of the reserve" to prevent a deduction for contingent losses.

Despite the fact that Mimeograph 6209 was intended to allow for bad debt reserve deductions respecting "the probable annual accruing loss", and despite the fact that said Mimeograph emphasized that such "annual accruing loss" would not be reflected in bad debt losses actually sustained, but would be in the nature of depreciation of capital with losses anticipated to be sustained in the future (even as recognized by Congressional Tax Committees), the lower Court accepted the Commissioner's mathematical computation under the Mimeograph and related Rules, and then specifically rejected the premises for the Commissioner's entire mathematical procedure.

In the words of the Appeals Court —

> "* * * The fallacy of the Bank's position in this case is that it attempted to set up a contingency reserve account for possible future losses and not a reasonable allowable deduction for bad debt reserve for income tax purposes as provided by Section 23(k)(1), 166(a), 26 U.S.C. * * "
> (citing *S. W. Coe & Co. v. Dallman*, 7 Cir., 1954, 216 F. 2d 566.)

Here then the anomaly of the Commissioner's mathematical application of a formula at variance with the basic premises that originally suggested the formula procedure. Here then the further anomaly that the lower Court accepted the result of the mathematical formula application, while at the same time denying the premises upon which the formula is based. All, incidentally, to the prejudicial discrimination of plaintiff-appellant as the District Court acknowledged in its opinion.

As recently stated by the United States Court of Appeals for the Fifth Circuit in *Commissioner v. The Chase Manhattan Bank*, 259 F. 2d 231, 2 A.F.T.R. 2d 6363 —

> "* * * The Commissioner owes a duty to the United States government to litigate zealously in the interest of collecting taxes. But he owes a duty to all taxpayers, including the litigating taxpayer, to see that the tax law is applied justly."

The United States Supreme Court should decide whether the Commissioner is performing the duty owed in respect of providing equally fair treatment to all banks in matter of income tax deductions represented by bad debt reserve additions. The United States Supreme Court should determine whether the Commissioner's premises in Mimeograph 6209, and related revenue rulings are valid, and whether the special bad debt reserve procedure provided therein is consistent with the Internal Revenue Code. Further, should the Supreme Court decide that such premises, are valid and reflect the law, then and in such case are the premises to be negated by slavish adherence to a mathematical formula as is reflected in the instant case.

In brief, the Supreme Court should take the opportunity of establishing conclusive determination in the important area involving bad debt reserve additions, and tax deductions, for the Nation's banks, which a decision on the instant case would necessarily provide.

CONCLUSION

The Circuit Court of Appeals for the Seventh Circuit has erroneously decided an income tax question that involves all banks in the United States using the bad debt reserve procedure. The decision conflicts with decisions

of the United States Court of Claims on matter of prejudicial discrimination, conflicts with published statements of Tax Writing Committees of Congress, and conflicts with published rulings of the Commissioner of Internal Revenue, and generally reflects the conflicting decisions of the courts on an important income tax issue of nationwide significance. Review by the United States Supreme Court is necessary and warranted. The petition for a writ of certiorari should be granted.

Respectfully submitted.

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Milwaukee 1, Wisconsin
Counsel for Petitioner

Date: August 22, 1960

APPENDIX A

OPINION IN THE

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH DISTRICT

SEPTEMBER TERM AND APRIL SESSION, 1960

No. 12876

AMERICAN STATE BANK, a Wisconsin banking corporation,
Plaintiff-Appellant,

v.

THE UNITED STATES OF AMERICA,
Defendant-Appellee.

No. 12877

AMERICAN STATE BANK, a Wisconsin banking corporation,
Plaintiff-Appellant,

v.

THE UNITED STATES OF AMERICA,
Defendant-Appellee.

On appeal from the United States District Court for the Eastern District of Wisconsin.

June 13, 1960

Before SCHNACKENBERG and CASTLE, *Circuit Judges*, and PLATT, *District Judge*.

PLATT, *District Judge*. Plaintiff, American State Bank, a Wisconsin banking corporation, has appealed from the decision of the district court dismissing its two suits to

obtain refunds for corporate income taxes. In one action plaintiff attempted to recover an alleged overpayment of corporate income tax in the amount of $6,320.54 for the year 1953, and in the other action $41,955.52 and $30,193.21 for the years 1954 and 1955 respectively. The overpayments were alleged to be due plaintiff for the reason that the Commissioner of Internal Revenue refused to allow the full amount claimed as addition to its bad debt reserve account for these taxable years. The two cases were consolidated for trial.

Plaintiff contends in substance:

(1) The district court's findings of fact were not supported by the evidence and were clearly erroneous; and

(2) The district court erred in concluding the Commissioner allowed a reasonable amount for the reserve account, because "of the Commissioner's slavish adherence to a formula with complete disregard of the facts and circumstances, and . . . of the statutory command that the additions be 'reasonable'."

The Internal Revenue Code of 1939 provided:

"Section 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(k) Bad Debts.—

(1) General Rule.—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; . . ."

and the Internal Revenue Code of 1954 provided:

"Section 166 Bad Debts.

(a) General Rule.—

(1) Wholly Worthless Debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * *

(c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts."

The measure of such reserve and the amounts to be allowed as deductions for 1953 is set forth in Mimeograph 6209, 1947-2 Cum. Bull. 26 as follows:

* * *

"2. In determining a reasonable annual addition to a reserve for bad debts by a bank it is believed to be fair and sufficiently accurate to resort to the average annual bad-debt loss of the bank over a period of 20 years, to include the taxable year, as constituting a representative period in the bank's history and accept the equivalent percentage of presently outstanding loans as indicative of the probable annual accruing loss. . . .

* * *

"5. A newly organized bank or a bank without sufficient years' experience for computing an average as provided for above will be permitted to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, subject to adjustment after a period of years when the bank's own experience is established.

"6. Bad debt losses sustained are to be charged to the reserve, and recoveries made of specific debts which have been previously charged against the reserve by a bank on the reserve method of treating bad debts should be credited to the reserve.

Mimeograph 6209 was supplemented in 1954 by Revenue Ruling 54-148, 1954-1 Cum. Bull. 60:

* * *

"Section 2. Background.

The Service has carefully reexamined the provisions of Mimeograph 6209, *supra*, in the light of experience developed thereunder and, as a result of such reexamination, has approved an alternative method for the use of banks in computing the annual addition to the reserve for bad debts. . . .

* * *

"Section 4. Alternative Method.

.01 In lieu of the moving average experience factor provided in paragraph 3 of Mimeograph 6209, which is determined on a basis of 20 years including the taxable year, a bank may use an average experience factor based on any 20 consecutive years of its own experience after the year 1927. Such average experience factor representing the percentage of bad debt losses to loans for the period selected, applied to loans outstanding at the close of the taxable year, determines the maximum permissible addition to the reserve for the year.

* * *

.03 Consistent with the provisions of Mimeograph 6209 which permit newly organized banks and banks without sufficient years' experience of their own to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, banks which select a 20-year period under (.01) above which extends back into years for which they have no experience of their own will be permitted to fill in such years with similar comparable data.

* * *"

The above rule was further clarified in 1957 by Revenue Ruling 57-350, 1957-2 Cum. Bull. 144, the pertinent part being:

> "For that portion of the 20-year period selected during which the bank was in existence, it is required to use its own experience. For that portion of the 20-year period selected during which the bank was not in existence, section 4.03 of Revenue Ruling 54-148, *supra*, permits a bank to fill in such years with the bad debt experience of other similar banks with respect to the same type of loans, preferably in the same locality. . . ."

The plaintiff Bank was organized in 1931 and with the consent of the Commissioner in 1945 changed from a specific bad debt deduction to a reserve account for bad debts in computing income tax. In 1947 the plaintiff Bank moved to a downtown location in Milwaukee.

The real controversy arises because the Commissioner disallowed deductions from income tax to the extent that these deductions for the reserve account for bad debts were based upon substituted loss ratio for the years the Bank was in actual existence. The plaintiff Bank in its return for 1953 determined its average loss ratio for the twenty year period ending with its taxable year by substituting the bad debt average percentage to total losses of member banks of the Seventh Federal Reserve District, of which it was a member, for the years 1934, 1935, and 1936 instead of its own percentages which were smaller. For the years 1954 and 1955 the plaintiff Bank used its average loss ratio for determining additions to its reserve account for bad debts the twenty year period from 1928 through 1947 except it substituted the Seventh Federal Reserve District Banks' average loss ratio for the years 1928 through 1936.

The parties stipulated a large portion of the facts which will not be repeated here since these facts are stated in the opinion of the district court 176 F. Supp. 64. The district court also heard testimony and made the following findings of fact:

(1) "The evidence does not show that the Bank's loss experience has been or will be materially altered as a result of its move to a downtown location.

(2) "The loss experience of two comparable Milwaukee banks . . . does not support a finding that the plaintiff Bank has a reasonable expectation of substantially increased bad debt losses.

(3) The evidence did not show "that the borrowed experience [of the Seventh Federal Reserve District Banks] has any relevancy to the Bank's business circumstances, the nature of its outstanding loans, its loan policy, or its anticipated losses, except to the extent that the Bank is a member of that District.

(4) "The [evidence] here does not support a finding of present or anticipated future losses which establish the insufficiency of allowed additions to reserves or the inadequacy of the accumulated reserve. . . ."

The district court concluded "[t]he [plaintiff] Bank has not met its heavy burden of showing that the Commissioner's determinations in question here are unreasonable or arbitrary."

A review of the stipulated facts discloses that plaintiff Bank moved to its downtown location in 1947. The average percentage of losses to total loans was greater for the sixteen year period from 1932 through 1947 than it was during the six year period from 1948 through 1953 after it moved; (This supports the district court's first

finding of fact.) that the loss experience of the two comparable downtown Milwaukee banks showed a greater loss percentage than those of the plaintiff Bank for the 1930's and for some years of the early 1940's; that the two comparable downtown banks had a difference in average loss ratio themselves for the period of 1938 through 1947. One of these banks had an average loss ratio for years 1940 through 1947 which evidently indicated that there was an excess of bad debt collections over bad debts charged off, in other words there was an average gain ratio instead of an average loss ratio; that one of the comparable downtown banks, which was organized in 1929 used the Seventh Federal Reserve District loss ratio for the years 1928 and 1929, and its own loss ratio for the years that it was in existence. The other comparable bank was in existence in 1928 and used its actual loss ratio of bad debts to loans as its loss ratio during these years. One of these banks sustained heavy losses shortly after its organization in 1929; (The foregoing facts support the district court's second finding of fact.) that the plaintiff Bank had a lower percentage loss ratio on bad debts during the 1930's than the Seventh Federal Reserve District Banks except for the years 1937, 1938, and 1939. That from 1940 through 1953 plaintiff Bank had an average loss ratio of .0745 and the Seventh Federal Reserve District Banks had a loss ratio of .0577. (The foregoing supports the district court's third finding of fact.)

The President of the plaintiff Bank testified that he expected losses conforming to the loss experience of the other banks in the Seventh Federal Reserve District if conditions of the depression were again repeated; that in the years 1953 through 1955 it was predominantly a commercial bank making commercial loans from one to five

years duration; that the plaintiff Bank was less liberal in its loan policy in 1938 and 1939 than in 1953 through 1955 when the economic conditions were better; that after moving downtown in 1947 the Bank's commercial loan volume increased considerably; that these loans were made in larger amounts to bigger business entities than before; that he believed the large loans did increase the risk but not the percentage of loss; that he could not remember any recession during the period the Bank was in existence when its reserve for bad debts was not sufficient to cover the bad debt losses, and this included the "recession" of 1958. The stipulated facts disclose that plaintiff's reserve for bad debts has increased from $53,754.78 on January 1, 1953, to approximately $89,350.00 on January 1, 1956, over $35,000.00, and in the same period the uninsured loans outstanding increased from approximately eleven and one-half million to fourteen and one-half million dollars. This demonstrates that the ratio of the reserve for bad debts to total loans increased substantially. (The testimony and stipulated facts support the fourth finding of fact of the district court.)

There were other stipulated facts and additional testimony of the President of the plaintiff Bank than are set forth above. We realize that this court is in the same position as the district court to make findings of fact based upon stipulated evidence. Some courts have held under such a state of proof that the appellate court is free from rule 52(a), Fed. Rules Civ. Proc., 28 U.S.C.; *Chicago, Burlington & Quincy R. Co.* v. *United States*, 7 Cir., 1955, 221 F. 2d 811; *Gilgel* v. *C.I.R.*, 6 Cir., 1959, 273 F. 2d 206. Other appellate courts have held to the contrary. *C.I.R.* v. *Consolidated Premium Iron Ores, Limited*, 6 Cir., 1959, 265 F. 2d 320; *Texas Company* v. *R. O'Brien & Co.*, 1 Cir., 1957, 242 F. 2d 526. It has

also been held that where conflicting reasonable inferences may be fairly drawn from undisputed facts weight must be given to the findings of the trial court, as well as where such findings are given weight by the credibility of the witness. *United States* v. *United States Gypsum Co.*, 1948, 333 U.S. 364, 394; *Central Ry. Signal Co.* v. *Longden*, 7 Cir., 1952, 194 F. 2d 310. Since we agree with the district court's findings of fact and these findings are not clearly erroneous the difference of opinion as to the conclusiveness of findings of fact by the district court have no effect here.

The question is then presented whether the district court misapplied the law in determining that the Commissioner's rulings in disallowing the additional deductions to the reserve account were unreasonable or arbitrary. In utilizing the reserve method for the purpose of bad debt deductions under §23(k)(1), (I.R.C., 1939), or §166(c), (I.R.C., 1954), 26 U.S.C., a taxpayer subjects himself to the reasonable discretion of the Commissioner. *Union National Bank and Trust Co. of Elgin*, 1956, 26 T.C. 537; *First National Bank of LaFeria*, 1955, 24 T.C. 429, affirmed 5 Cir., 1956, 234 F. 2d 868. If the Commissioner's determination as to amount of addition is reasonable there is no abuse of discretion, *S. W. Coe & Co.* v. *Dallman*, 7 Cir., 1954, 216 F. 2d 566. Defendant relies heavily on this case where at page 569 the court in referring to the Commissioner stated:

> "[S]lavish adherence to a formula might, under certain conditions, result in an unreasonable addition to a bad debt reserve, or a failure to make any additions. . . ."

The plaintiff Bank omits to take into consideration the further remarks of this court when it stated:

> "The District Court approved the additions determined by the Commissioner not because the Commis-

sioner reached the result by use of the formula, but only because the additions were reasonable and adequate under the evidence."

From the district court's opinion here it is clear that the Commissioner's determination of reductions of the claimed addition to the reserve account for bad debts was held to be "reasonable and adequate under the evidence" and not "because the Commissioner reached the result by the use of a formula." The Bank was permitted to use reasonable discretion in resolving what debts became worthless during the taxable year, but it was necessary that the Commissioner use a mathematical formula under the facts to ascertain the amount to be added each year to the reserve account. *Paramount Liquor Co.* v. *Commissioner of Int. Rev.*, 5 Cir., 1957, 242 F. 2d 249. The fallacy of the Bank's position in this case is that it attempted to set up a contingency reserve account for possible future losses and not a reasonable allowable deduction for bad debt reserve for income tax purposes as provided by §§23 (k) (1), 166(a), 26 U.S.C.; *S. W. Coe & Co.* v. *Dallman, supra.* The district court properly concluded that where the Commissioner had allowed an addition to the bad debt reserve of the taxpayer, the latter has a heavy burden to show the Commissioner's abuse of discretion. *Paramount Liquor Co.* v. *Commissioner of Int. Rev., supra; S. W. Coe & Co.* v. *Dallman, supra; Maverick-Clarke Litho Co.* v. *C. I. R.*, 5 Cir., 1950, 180 F. 2d 587; *Morris Plan Ind. Bank* v. *Commissioner of Int. Rev.*, 2 Cir., 1945, 151 F. 2d 976. The plaintiff Bank did not meet its heavy burden of proving that the Commissioner acted arbitrarily

and unreasonably when he disallowed the full amount of its deductions for its reserve account for bad debts.

The order of the district court dismissing plaintiff's two suits is

AFFIRMED.

JUDGMENT IN THE UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Chicago 10, Illinois

Monday, June 13, 1960

Before

Hon. ELMER J. SCHNACKENBERG, Circuit Judge

Hon. LATHAM CASTLE, Circuit Judge

Hon. CASPER PLATT, District Judge

AMERICAN STATE BANK, a Wisconsin banking corporation,
Plaintiff-Appellant,

Nos. 12876-77

vs.

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court for the Eastern District of Wisconsin.

This cause came on to be heard on the transcript of the record from the United States District Court for the Eastern District of Wisconsin, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in this cause appealed from be, and the same are hereby, AFFIRMED, IN ACCORDANCE WITH THE OPINION OF THIS FILED THIS DAY.

APPENDIX B

STATUTES, REGULATIONS AND RULINGS INVOLVED

Statutes

Section 23. Internal Revenue Code of 1939:

Section 23. *Deductions from Gross Income.*

In computing net income there shall be allowed as deductions:

* * * *

(k) *Bad Debts.*—

(1) General Rule. — Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; * * * *

(26 U.S.C. (I.R.C. 1939) 1952 ed., Sec. 23 (k), Volume Three, p. 3296)

Section 166. Internal Revenue Code of 1954:

Section 166. *Bad Debts.*

(a) General Rule.—

(1) Wholly Worthless Debts. — There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially Worthless Debts. — When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of Deduction. — For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * *

(26 U.S.C. (I.R.C.1954) 1952 Ed. Supp. IV, Sec. 166, Volume Two, p. 1518)

Regulations

Treasury Regulations 118, Paragraph 39.23(k)-1; Internal Revenue Code of 1939:

39.23(k)-1. *Bad debts.* (a) Bad debts may be treated in either of two ways—

(1) By a deduction from income in respect of debts which become worthless in whole or in part, or

(2) By a deduction from income of an addition to a reserve for bad debts.

(b) Taxpayers were given a similar option for 1921 to select either of the methods mentioned for treating such debts. (See article 151, Regulations 62.) While ascertainment of worthlessness and chargeoff during the taxable year (which were prerequisite to deduction of a bad debt under the law at that time) are no longer required for the allowance of a debt which becomes wholly worthless, the method used in the return for 1921 must be used in returns for all subsequent years unless permission is granted by the Commissioner to change to the other method. A taxpayer filing a first return of income may select either of the two methods subject to approval by the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Commissioner to change to another method. Application for permission to change the method of treating bad

debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective. (See also 39.23(k)-5.)

Treasury Regulations 118, Paragraph 39.23(k)-5; Internal Revenue Code of 1939:

39.23(k)-5. *Reserve for bad debts.* (a) Taxpayer other than mutual savings banks, building and loan associations, and cooperative banks. (1) Taxpayers who have established the reserve method of treating bad debts and maintained proper reserve accounts for bad debts, or who, in accordance with 39.23(k)-1, adopt the reserve method of treating bad debts, may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of a deduction for specific bad debt items.

(2) What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve. In case subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve should be reflected in the determination of the reasonable addition necessary in the taxable year. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have become wholly or partially worthless and have been charged against the reserve account.

Treasury Regulations, Internal Revenue Code of 1954:

§ 1.166-1 Bad Debts. (a) Allowance of deduction. Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) Manner of selecting method.—(1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

(2) Taxpayers who have properly selected one of the two methods for treating bad debts under provisions of prior law corresponding to section 166 shall continue to use that method for all subsequent taxable years unless the Commissioner grants permission to use the other method.

(3)(i) For taxable years beginning after December 31, 1959, application for permission to change the method of treating bad debts shall be made in accordance with section 446(e) and paragraph (e)(3) of § 1.446-1.

(ii) For taxable years beginning before January 1, 1960, application for permission to change to method of treating bad debts shall be made at least 30 days before the close of the taxable year for which the change is effective.

(c) Bona fide debt required. Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under section 166.

(d) Amount deductible—(1) General Rule. Except in the case of a deduction for a reasonable addition to a reserve for bad debts, the basis for determining the amount of deduction under section 166 in respect of a bad debt shall be the same as the adjusted basis prescribed by § 1.1011-1 for determining the loss from the sale or other disposition of property. To determine the allowable deduction in the case of obligations acquired before March 1, 1913, see also paragraph (b) of § 1.1053-1.

* * * *

§ 1.166-4 Reserve for Bad Debts. (a) Allowance of deduction. A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) Reasonableness of addition to reserve—(1) Relevant factors. What constitutes a reasonable ad-

dition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) Correction of errors in prior estimates. In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) Statement required. A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

(d) Special rule applicable to certain banking organizations. For special rule for the addition to the bad debt reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see § 1.593-1.

Rulings

Mim. 6209 (Cum. Bul. 1947-2, p. 26)

Section 29.23 (k)-5: Reserve for bad debt. 1947-25-12717.

1. The Bureau has given careful and extended consideration to the situation of banks in general with respect to the use of reserves for bad debts, the proper measure of such reserves, and amounts to be allowed as deductions.

2. In determining a reasonable annual addition to a reserve for bad debts by a bank it is believed to be fair and sufficiently accurate to resort to the average annual bad-debt loss of the bank over a period of 20 years, to include the taxable year, as constituting a representative period in the bank's history and to accept the equivalent percentage of presently outstanding loans as indicative of the probable annual accruing loss. The Tax Court has held that the "use of the reserve for bad debts is not inherently inconsistent with a cash basis where, as here, the reserve is against loss of capital only * * * and contains no element of income which has never been reported. * * * Such a reserve for loss of capital does not differ materially from a reserve for depreciation which is set up on a percentage basis rather than on the basis of actual depreciation suffered." (See Estate of Maurice S. Saltstein v. Commissioner, 46 B. T. A., 774. 777, acquiescence, C.B. 1942-1, 14.) However, such reserve can not be permitted to accumulate indefinitely simply because of the possibility that at some future date large losses may be concentrated within a relatively short period of time and operate to absorb the greatest probable reserve. To permit this would sanction the deduction of a mere contingency reserve for losses, which is not an allowable deduction for income or excess profits tax purposes. This latter rule makes imperative the imposition of some reasonable ceiling on the accumulation of the

reserve other than such indefinite limitation as might eventually prevail under a moving average method.

3. The Bureau has accordingly approved the use by banks of a moving average experience factor for the determination of the ratio of losses to outstanding loans for taxable years beginning after December 31, 1946. Such a moving average is to be determined on a basis of 20 years, including the taxable year, as representing a sufficiently long period of a bank's experience to constitute a reasonable cycle of good and bad years. The percentage so obtained, applied to loans outstanding at the close of the taxable year, determines the amount of permissible reserve in the case of a bank changing to the reserve method in such year (see first year in following computation) and the minimum reserve which the taxpayer will be entitled to maintain in future years (see second year in following computation). A bank, following a change to the reserve method of accounting for bad debts, may continue to take deductions from taxable income equal to the current moving average percentage of actual bad debts times the outstanding loans at the close of the year, or an amount sufficient to bring the reserve at the close of the year to the minimum mentioned above, whichever is greater. Such continued deductions will be allowed only in such amounts as will bring the accumulated total at the close of any taxable year to a total not exceeding three times the moving average loss rate applied to outstanding loans (see fifth year in the following computation).

4. In computing the moving average percentage of actual bad debt losses to loans, the average should be computed on loans comparable in their nature and risk involved to those outstanding at the close of the current taxable year involved. Government insured loans should be eliminated from prior year accounts in computing percentages of past losses, also from the current year loans in computing allow-

able deductions for additions to the reserve. Losses not in the nature of bad debts resulting from the ordinary conduct of the present business should also be eliminated in computing percentages of prior losses.

5. A newly organized bank or a bank without sufficient years' experience for computing an average as provided for above will be permitted to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, subject to adjustment after a period of years when the bank's own experience is established.

6. Bad debt losses sustained are to be charged to the reserve, and recoveries made of specific debts which have been previously charged against the reserve by a bank on the reserve method of treating bad debts should be credited to the reserve.

7. Where a bank making its return on the basis of the calendar year 1947 wishes to avail itself of the provisions of this mimeograph and to change from the specific charge-off to the reserve method of accounting for bad debts, the time for making application for such change under section 29.23(k)-1, Regulations 111, has been extended to March 15, 1948 (T.D. 5594, approved December 8, 1947 (page 25 this Bulletin)). If such bank files its return on or before March 15, 1948, on the reserve method, and the return is accompanied by a written statement setting forth the election to use such method and explaining in detail the computations of the bad debt deduction shown in the return, such return will be accepted as a timely application.

8. The term "banks" as used herein means banks or trust companies incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business

of which consists of receiving deposits and making loans and discounts.

9. Correspondence in regard to this mimeograph should refer to the number and to the symbols IT:EIM.

Regulations 118, Section 39.23(k)-5: *Reserve for bad debts.* Rev. Rul. 54-148* (Cum. Bul. 1954-1, p. 60)

*Originally issued as IR Mimeograph No. 54-55, dated April 8, 1954.

A bank, in computing a reasonable addition to its reserve for bad debts, may use an average experience factor based on any 20 consecutive years of experience after 1927, in lieu of a moving average experience factor determined on a basis of 20 years including the taxable year.

Com.-Mimeograph Coll. No. 6209, C. B. 1947-2, 26, Supplemented.

Section 1. Purpose.

The purpose of this Revenue Ruling is to supplement Com.-Mimeograph Coll. No. 6209 dated December 8, 1947 (C. B. 1947-2, 26), which authorizes, in the case of banks, a special method for computing a reasonable addition to the reserve for bad debts under section 23(k) (1) of the Internal Revenue Code and the regulations promulgated thereunder.

Section 2. Background.

The Service has carefully reexamined the provisions of Mimeograph 6209, supra, in the light of experience developed thereunder and, as a result of such reexamination, has approved an alternative method for the use of banks in computing the annual addition to the reserve for bad debts and the maximum amount permitted to be accumulated in such reserve, as set forth in section 4 hereunder.

Section 3. Definition of Terms.

The term "banks" as used herein means banks or trust companies incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts. Such term as used in Mimeograph 6209 and herein does not include mutual savings banks not having capital stock represented by shares, domestic building and loan associations, or cooperative banks without capital stock organized and operated for mutual purposes and without profit.

Section 4. Alternative Method.

.01 In lieu of the moving average experience factor provided in paragraph 3 of Mimeograph 6209, which is determined on a basis of 20 years including the taxable year, a bank may use an average experience factor based on any 20 consecutive years of its own experience after the year 1927. Such average experience factor, representing the percentage of bad debt losses to loans for the period selected, applied to loans outstanding at the close of the taxable year, determines the maximum permissible addition to the reserve for the year.

.02 The amounts permitted to be added in each taxable year to the bad debt reserve under (.01) above may not exceed an amount which will bring the accumulated total in the bad debt reserve at the close of the taxable year to a ceiling equal to three times the average experience factor applied to outstanding loans: Provided,

1. That for the first taxable year beginning after December 31, 1953, the amount of the addition therein to the reserve computed under (.01) above may not exceed one-third of the difference between the ceiling so computed and the accumulated total in the reserve at the close of the year before the addition; and

2. That for the second taxable year beginning after December 31, 1953, the amount of the addition therein to the reserve computed under (.01) above may not exceed one-half of the difference between the ceiling so computed and the accumulated total in the reserve at the close of the year before the addition.

.03 Consistent with the provisions of Mimeograph 6209 which permit newly organized banks and banks without sufficient years' experience of their own to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, banks which select a 20-year period under (.01) above which extends back into years for which they have no experience of their own will be permitted to fill in such years with similar comparable data.

.04 The provisions of paragraph 6 of Mimeograph 6209 relating to the treatment of specific bad debt losses and recoveries, and all other rules utilized in the application of Mimeograph 6209 shall, to the extent not inconsistent, be applicable to the alternative method.

Section 5. Effect on Other Documents.

This Revenue Ruling merely supplements Mimeograph 6209 by providing an additional or alternative method for computing the annual addition to a reserve for bad debts and the maximum amount permitted to be accumulated in such reserve. Banks which are now using the moving average method provided in Mimeograph 6209 may continue to use that method if they so desire, and such method is still available to any other banks using or changing to the reserve method of accounting for bad debts.

Section 6. Banks on Specific Charge-off Method.

Where a bank on the specific charge-off method of accounting for bad debts desires to avail itself of the

provisions of this Revenue Ruling and change to the reserve method, application to make such change must be made in the manner prescribed by section 39.23(k)-1, Regulations 118.

Section 7. Effective date.

The provisions of this Revenue Ruling are applicable only for taxable years beginning after December 31, 1953.

Approved by M. B. Folsom, Acting Secretary of the Treasury, April 8, 1954.

Section 166.—*Bad Debts.* Rev. Rul. 57-350. (Cum. Bul. 1957-2, p. 144)

In Revenue Ruling 54-148, C.B. 1954-1, 60, an alternative method of computing additions to a reserve for bad debts was approved for use by banks in lieu of the 20-year moving average method authorized in Mimeograph 6209, C. B. 1947-2, 26. Such alternative method contemplates that each bank using the reserve method of accounting for bad debts may select any 20 consecutive years after the year 1927 as an experience factor base, regardless of whether the bank was in existence, and therefore had experience of its own, for all or part of the 20-year period selected. For that portion of the 20-year period selected during which the bank was in existence, it is required to use its own experience. For that portion of the 20-year period selected during which the bank was not in existence, section 4.03 of Revenue Ruling 54-148, supra, permits a bank to fill in such years with the bad debt experience of other similar banks with respect to the same type of loans, preferably in the same locality. Thus, for example, a bank with continuous existence since December 31, 1933, may select the period 1930 through 1949, use its own bad debt experience for the years 1934 through 1949, and fill in the years 1930 through 1933 with the bad debt experience for those years of other similar banks, preferably in the same locality.

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No. 360

In the Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN STATE BANK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

J. LEE RANKIN,
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AMERICAN STATE BANK, PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the District Court (R. 6a-18a)[1] are reported at 176 F. Supp. 64. The opinion of the Court of Appeals (Pet. 26-36) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on June 13, 1960. (Pet. 37.) The petition for a

[1] Record references are to the appendix to the taxpayer's brief as filed in the Court of Appeals.

writ of certiorari was filed on August 24, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the additions to taxpayer's reserve for bad debts as allowed by the Commissioner under the authority of Section 23(k)(1) of the Internal Revenue Code of 1939 and Section 166(c) of the 1954 Code are reasonable and adequate.

STATUTES AND OTHER AUTHORITIES INVOLVED

Section 23(k)(1) of the Internal Revenue Code of 1939; Section 166(c) of the Internal Revenue Code of 1954; Section 39.23(k)-5 of Treasury Regulations 118; Section 1.166-4 of Treasury Regulations (1954 Code); Mim. 6209, 1947-2 Cum. Bull. 26; Rev. Rul. 54-148, 1954-1 Cum. Bull. 60; Rev. Rul. 57-350, 1957-2 Cum. Bull. 144 are set forth in the Appendix, *infra*, pp. 12-19.

STATEMENT

The material facts as stipulated (R. 21a-30a, 36a-38a) and found by the District Court (R. 8a-11a) may be summarized as follows:

The taxpayer, American State Bank, was organized as a banking corporation under the laws of Wisconsin in 1931. Its sole place of business is in the City of Milwaukee, Wisconsin, at a downtown location to which it moved in 1947. (R. 8a.)

Beginning with the year 1945, the taxpayer, with the consent of the Commissioner, has used the reserve method of accounting for bad debts for federal income tax purposes. (R. 8a.) The deductions claimed by the taxpayer for 1953-1955 as additions to the reserve, and the loss ratios on which such additions were based, were (R. 8a):

1953	$ 42,392.16	.3679%
1954	95,640.84	.9326%
1955	81,576.62	.9226%

The deductions ultimately allowed as additions to the reserve by the Commissioner and the respective loss ratios were (R. 8a):

1953	$ 30,087.80	.11808%
1954	14,957.15	.2608%
1955	23,512.74	.2608%

The taxpayer's net uninsured loans outstanding for the years 1953, 1954, and 1955, respectively, were $11,482,107.69, $12,624,493.02, and $14,427,460. The taxpayer's net charge-offs for the same years, respectively, amounted to $32,834.48, ($2,894.49), and $3,004.77, while its reserves for bad debts as of January 1 of each of the years 1953, 1954, 1955, and 1956, were respectively $53,754.78, $51,000, $68,850, and $89,350. The amounts shown for the last three dates are approximate amounts arrived at by charging the excess of allowed additions over net charge-offs. (R. 9a.)

The taxpayer is a member bank of the Seventh Federal Reserve District. The Marshall & Ilsley Bank and the Bank of Commerce may be considered

comparable to the taxpayer in location and nature of loans. Loss ratios of these banks for the relevant years were as follows (R. 10a):

Year	The Taxpayer	Seventh Federal Reserve District Member Banks	Marshall & Ilsley Bank	The Bank of Commerce
1928	Not in existence	0.329%	.29179%	.3290%
1929	" " "	.554	.37490	.5544
1930	" " "	.563	.60530	.0000
1931	.0.000%	1.306	1.05720	.0260
1932	0.000	2.565	1.69307	3.9820
1933	0.000	6.475	.57182	(.0403)
1934	.610	3.625	2.23646	.7771
1935	1.355	1.570	5.12096	2.9305
1936	(.297)	.870	1.71450	7.0405
1937	.005	(.181)	.49956	2.1211
1938	.232	.009	.49085	.5904
1939	.033	(.034)	.77021	.1291
1940	.158	(.139)	.11844	(.1417)
1941	.110	(.095)	(.32958)	.3753
1942	.446	(.177)	(.2573)	.3834
1943	(.079)	(.307)	.00754	.0530
1944	(.105)	(.177)	.07627	.3522
1945	(.026)	(.135)	(.14084)	.0845
1946	.010	(.018)	.02363	(.0094)
1947	.009	.053	.00942	.0616
1948	.139	.068	Not available	Not available
1949	(.002)	.099	" "	" "
1950	.038	(.025)	" "	" "
1951	.011	.005	" "	" "
1952	.048	.004	" "	" "
1953	.286	.035	" "	" "

To determine additions to reserve for the year 1953, the taxpayer used a loss ratio based on the 20-year period ending with its taxable year and substituted the bad debt loss experience of member banks of the Seventh Federal Reserve District for the years 1934, 1935, and 1936. (R. 11a.)

For the years 1954 and 1955, the taxpayer used the 20-year period from 1928 through 1947 and substituted the Seventh Federal Reserve District percentage for the years 1928 through 1936. (R. 11a.)

The Commissioner disallowed deductions to the extent that they were based on substituted loss ratios for the years the taxpayer was in actual existence. (R. 11a.) On the basis of the facts of record, the District Court sustained the Commissioner's determinations (R. 11a-18a) and the Court of Appeals affirmed (Pet. 26-36).

ARGUMENT

The decision here turns on the facts of the particular case, there is no conflict, and no other reason exists for further review by this Court.

1. Under the provisions of Section 23(k)(1) of the 1939 Code, a taxpayer is allowed a deduction in computing net income for "Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; * * *." Section 166(c) of the 1954 Code is to the same effect.[2] The taxpayer elected in 1945 to use the so-called "reserve method" of computing its deductions under these sections of the Codes in lieu of a deduction for specific debt items which become worthless during the taxable years.

[2] For convenience, specific reference hereafter will be made only to the 1939 Code section.

As the Court of Appeals observed (Pet. 34), a taxpayer utilizing the reserve method for bad debt deductions submits himself to the reasonable discretion of the Commissioner. Repeatedly, the courts have stated that the taxpayer has a "heavy burden" of proving that the Commissioner, in disallowing a part of the addition to the reserve claimed by the taxpayer, abused the broad discretion specifically granted to him by Congress. See, for example, *Maverick-Clarke Litho Co.* v. *Commissioner*, 180 F. 2d 587, 592 (C.A. 5th); *Morris Plan Ind. Bank* v. *Commissioner*, 151 F. 2d 976 (C.A. 2d); *Art Metal Const. Co.* v. *United States*, 17 F. Supp. 854 (C. Cls.). Consistent with this standard, the Court of Appeals, affirming the trial court, held that the taxpayer failed to prove that the Commissioner acted arbitrarily and unreasonably in the instant case. (Pet. 35-36.) This holding, we submit, is correct.

What constitutes a reasonable addition to a reserve for bad debts, regardless of formula, must be determined upon the facts and circumstances of a particular class of business and with relationship to the conditions of business prosperity. *S. W. Coe & Co.* v. *Dallman*, 216 F. 2d 566 (C.A. 7th); *Black Motor Co.* v. *Commissioner*, 41 B.T.A. 300, 304, affirmed, 125 F. 2d 977 (C.A. 6th); Treasury Regulations 118, Sec. 39.23(k)-5; Treasury Regulations on Reserve for Bad Debts (1954 Code), Sec. 1.166-4. Section 39.23 (k)-5 of Treasury Regulations 118 (Appendix, *infra*, pp. 12-13) further provides that a reasonable addition to a reserve for bad debts "will depend primarily upon the total amount of debts outstanding as of the

close of the taxable year, those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve." Section 1.166-4 of the 1954 Code Treasury Regulations (Appendix, *infra*, p. 13) is to the same effect. The reserve itself must be adequate to absorb the bad debts that might probably arise. *Krim-Ko Corp.* v. *Commissioner*, 16 T.C. 31; *Newlin Machinery Corp.* v. *Commissioner*, 28 T.C. 837.

The Commissioner, pursuant to the discretion given him by Congress, has approved the use by commercial banks of a method of computing deductions for reasonable additions to a reserve for bad debts under Section 23(k)(1) of the Code and the Regulations promulgated thereunder. Mim. 6209, 1947-2 Cum. Bull. 26 (Appendix, *infra*, pp. 13-16). In this ruling, the Commissioner has set forth a formula which provides for additions to the reserve based upon the average ratio, over a 20-year period ending with the taxable year, of bad debt losses to loans outstanding at the close of the year. Mim. 6209 permitted newly organized banks and banks without sufficient years' experience of their own to set up a reserve commensurate with the experience of similar banks but expressly subjecting such supplementation to adjustment after a period of years when the bank's own experience was established.

For tax years beginning after December 31, 1953, the Commissioner, in Rev. Rul. 54-148, 1954-1 Cum. Bull. 60 (Appendix, *infra*, pp. 16-18), supplemented Mim. 6209 and approved, as an alternative method for the computation of reasonable additions to a bad

debt reserve, the use of an average experience factor based upon a bank's experience over any 20 consecutive year period after 1927. Consistent with the provisions of Mim. 6209, Rev. Rul. 54-148 provided that a bank which selected a 20-year period extending back into years for which it had no experience would be permitted to fill in such years with similar comparable data. The Commissioner amplified the rulings in Rev. Rul. 57-350, 1957-2 Cum. Bull. 144 (Appendix, *infra*, pp. 18-19), and further explained that for the portion of the 20-year period selected during which the bank was in existence it would be required to use its own experience, and that for the portion the bank was not in existence it would be permitted to supplement its own experience with the bad debt experience of similar banks.

The nub of the instant controversy is that, although the taxpayer recognizes the formulae used to derive the reasonable additions allowed by the Commissioner, in order to obtain a greater deduction the taxpayer wishes to modify the formulae by substituting loss ratios of other banks for its own experience during years it was in actual existence. (R. 11a.) The Commissioner disallowed the taxpayer's deductions to the extent that the additions to the reserve were based upon substituted experience for the years the taxpayer was in existence and had its own experience. (Pet. 30.) The Commissioner's determinations were sustained by the courts below.

The taxpayer claims (Pet. 10) that the additions allowed it were unreasonable because they were not as great as those of two comparable downtown Mil-

waukee banks nor as great as those of the Seventh Federal Reserve District member banks, and that such treatment is prejudicial discrimination. The Court of Appeals, in a detailed review of the evidence (Pet. 32-33), found substantial support for the District Court's findings of fact that the loss experience of the two downtown banks did not support a reasonable expectation of substantially increased bad debt losses on the part of the taxpayer, and further found that the substituted experience of the Seventh Federal Reserve District member banks was without pertinent relevancy to the taxpayer's circumstances, the nature of its outstanding loans, its loan policy, or its anticipated loss. In addition, it found nothing to support a finding of present or anticipated future losses which would establish the insufficiency of the allowed additions to reserves or the inadequacy of accumulated reserves. Rather the reserves had been completely sufficient and, in fact, during the taxable years the ratio of the reserve for bad debts to total loans increased substantially.[7] (Pet. 33.) Based upon these and other facts of record, the court below held that the Commissioner's determinations of the allowable additions to the reserve for the taxable years were reasonable and adequate, and that the Commis-

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[7] Contrary to the taxpayer's argument (Pet. 11-16), in discussing an exception for excess profits tax purposes to the bad debt reserve method permitted under Mim. 6209, the congressional reports cited by the taxpayer recognize the validity of the principle and practice under Mim. 6209. The excess profits tax exception is, of course, without pertinency here.

sioner had not abused his discretion. These holdings are correct, are of a factual nature, and do not warrant further review.

2. The taxpayer's claim (Pet. 8, 12-13) that the decision of the court below is in "direct" conflict with two Court of Claims cases is totally without merit. Neither case concerns reasonable additions to reserves for bad debts for commercial banks or any other business nor do they concern the application of the Commissioner's discretion under Section 23(k)(1). In *Exchange Parts Co. of Fort Worth* v. *United States*, 279 F. 2d 251, a case concerning excise taxes on sales of rebuilt generators and clutch assemblies, the Court of Claims did not give effect to the retroactive feature of a ruling changing a prior position, where that aspect of the ruling was applicable solely to taxpayers who had paid the tax. Similarly, in *Connecticut Railway and Lighting Co.* v. *United States*, 142 F. Supp. 907, the Court of Claims deemed the retroactive aspect of a reversal in position in a ruling to be invalid and prejudicially discriminating where the retroactivity was limited solely to taxpayers who had paid their tax. In no wise was there a retroactive change involved in the instant case; rather, there was a continuing liberalization of what is considered reasonable within the meaning of the pertinent statutes.

Not only is there no conflict but the decision below sustaining the Commissioner's action is in complete accord with *First National Bank of La Feria* v. *Commissioner*, 234 F. 2d 868 (C.A. 5th), a case

directly in point on the application of the formula set forth in Mim. 6209. The Fifth Circuit affirmed the Tax Court's findings (24 T.C. 429) that since that taxpayer had been in existence during the years it desired to substitute another bank's experience, and since that taxpayer's actual bad debt losses for the years in question were more in line with its own moving average ratios based on its own bad debt experience, it was improper to use the experience of a substituted bank instead of its own.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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SEPTEMBER, 1960

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) *Bad debts.*—

(1) *General rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; * * *

* * * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 166. BAD DEBTS.

(a) *General rule.*—

* * * * *

(c) *Reserve for bad debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * * *

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.23(k)-5. *Reserve for bad debts*—(a) * * * (2) What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. It will depend primarily

upon the total amount of debts outstanding as of the close of the taxable year, those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve. * * *

Treasury Regulations under the Internal Revenue Code of 1954:

SEC. 1.166-4. *Reserve for bad debts.* * * *

(b) *Reasonableness of addition to reserve.*— (1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

* * * * *

Mim. 6209, 1947-2 Cum. Bull. 26:

1. The Bureau has given careful and extended consideration to the situation of banks in general with respect to the use of reserves for bad debts, the proper measure of such reserves, and amounts to be allowed as deductions.

2. In determining a reasonable annual addition to a reserve for bad debts by a bank it is believed to be fair and sufficiently accurate to resort to the average annual bad-debt loss of the bank over

a period of 20 years, to include the taxable year, as constituting a representative period in the bank's history and to accept the equivalent percentage of presently outstanding loans as indicative of the probable annual accruing loss. The Tax Court has held that the "use of the reserve for bad debts is not inherently inconsistent with a cash basis where, as here, the reserve is against loss of capital only * * * and contains no element of income which has never been reported. * * * Such a reserve for loss of capital does not differ materially from a reserve for depreciation which is set up on a percentage basis rather than on the basis of actual depreciation suffered." (See *Estate of Maurice S. Saltstein* v. *Commissioner*, 46 B.T.A. 774, 777, acquiescence, C.B. 1942-1, 14.) However, such reserve cannot be permitted to accumulate indefinitely simply because of the possibility that at some future date large losses may be concentrated within a relatively short period of time and operate to absorb the greatest probable reserve. To permit this would sanction the deduction of a mere contingency reserve for losses, which is not an allowable deduction for income or excess profits tax purposes. This latter rule makes imperative the imposition of some reasonable ceiling on the accumulation of the reserve other than such indefinite limitation as might eventually prevail under a moving average method.

3. The Bureau has accordingly approved the use by banks of a moving average experience factor for the determination of the ratio of losses to outstanding loans for taxable years beginning after December 31, 1946. Such a moving average is to be determined on a basis of 20 years,

including the taxable year, as representing a sufficiently long period of a bank's experience to constitute a reasonable cycle of good and bad years. The percentage so obtained, applied to loans outstanding at the close of the taxable year, determines the amount of permissible reserve in the case of a bank changing to the reserve method in such year (see first year in following computation) and the minimum reserve which the taxpayer will be entitled to maintain in future years (see second year in following computation). A bank, following a change to the reserve method of accounting for bad debts, may continue to take deductions from taxable income equal to the current moving average percentage of actual bad debts times the outstanding loans at the close of the year, or an amount sufficient to bring the reserve at the close of the year to the minimum mentioned above, whichever is greater. Such continued deductions will be allowed only in such amounts as will bring the accumulated total at the close of any taxable year to a total not exceeding three times the moving average loss rate applied to outstanding loans (see fifth year in following computation).

Example of the application of foregoing with amount of outstanding loans remaining unchanged at $1,000,000

Year	Moving average percentage	Actual bad debts for year	Deduction	Reserve at end of year	Ceiling
1	1.0	$ 2,000	$12,000	$10,000	$30,000
2	.8	11,500	9,500	8,000	24,000
3	.7	1,000	7,000	14,000	24,000
4	.8	1,000	8,000	21,000	24,000
5	1.0	500	9,500	30,000	30,000

* * * *

5. A newly organized bank or a bank without sufficient years' experience for computing an average as provided for above will be permitted to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, subject to adjustment after a period of years when the bank's own experience is established.

* * * *

Rev. Rul. 54-148, 1954-1 Cum. Bull 60:

Sec. 1. Purpose.

The purpose of this Revenue Ruling is to supplement Com.-Mimeograph Coll. No. 6209 dated December 8, 1947 (C.B. 1947-2, 26), which authorizes, in the case of banks, a special method for computing a reasonable addition to the reserve for bad debts under section 23(k)(1) of the Internal Revenue Code and the regulations promulgated thereunder.

Sec. 2. Background.

The Service has carefully reexamined the provisions of Mimeograph 6209, *supra*, in the light of experience developed thereunder and, as a result of such reexamination, has approved an alternative method for the use of banks in computing the annual addition to the reserve for bad debts and the maximum amount permitted to be accumulated in such reserve, as set forth in section 4 hereunder.

* * * *

Sec. 4. Alternative Method.

.01 In lieu of the moving average experience factor provided in paragraph 3 of Mimeograph 6209, which is determined on a basis of 20 years including the taxable year, a bank may use an average experience factor based on any 20 consecutive years of its own experience after the year 1927. Such average experience factor representing the percentage of bad debt losses to loans for the period selected, applied to loans outstanding at the close of the taxable year, determines the maximum permissible addition to the reserve for the year.

.02 The amounts permitted to be added in each taxable year to the bad debt reserve under (.01) above may not exceed an amount which will bring the accumulated total in the bad debt reserve at the close of the taxable year to a ceiling equal to three times the average experience factor applied to outstanding loans: * * *.

.03 Consistent with the provisions of Mimeograph 6209 which permit newly organized banks and banks without sufficient years' experience of their own to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, banks which select a 20-year period under (.01) above which extends back into years for which they have no experience of their own will be permitted to fill in such years with similar comparable data.

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Sec. 5. Effect on Other Documents.

This Revenue Ruling merely supplements Mimeograph 6209 by providing an additional or alter-

native method for computing the annual addition to a reserve for bad debts and the maximum amount permitted to be accumulated in such reserve. Banks which are now using the moving average method provided in Mimeograph 6209 may continue to use that method if they so desire, and such method is still available to any other banks using or changing to the reserve method of accounting for bad debts.

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Rev. Rul. 57-350, 1957-2 Cum. Bull. 144:

In Revenue Ruling 54-148, C.B. 1954-1, 60, an alternative method of computing additions to a reserve for bad debts was approved for use by banks in lieu of the 20-year moving average method authorized in Mimeograph 6209, C.B. 1947-2, 26. Such alternative method contemplates that each bank using the reserve method of accounting for bad debts may select any 20 consecutive years after the year 1927 as an experience factor base, regardless of whether the bank was in existence, and therefore had experience of its own, for all or part of the 20-year period selected. For that portion of the 20-year period selected during which the bank was in existence, it is required to use its own experience. For that portion of the 20-year period selected during which the bank was not in existence, section 4.03 of Revenue Ruling 54-148, *supra*, permits a bank to fill in such years with the bad debt experience of other similar banks with respect to the same type of loans, perferably in the same locality. Thus, for example, a bank with continuous existence since December 31,

1933, may select the period 1930 through 1949, use its own bad debt experience for the years 1934 through 1949, and fill in the years 1930 through 1933 with the bad debt experience for those years of other similar banks, preferably in the same locality.

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